Risk Management for Accountants: From Proposal to Withdrawal

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Introduction

Although lawsuits against accountants are nothing new, the publicity associated with several sensational lawsuits and business failures has added substantial tinder to what was already a large and seemingly growing fire. The need to generate and retain new business, despite an environment where lawsuits seem inevitable, remains constant. Doing so without being exposed to the risk of litigation has become increasingly more difficult. During such turbulent times, the implementation of a risk management plan allows an accounting firm to maximize revenues while minimizing the potential for costly litigation. The following materials are meant to assist the practitioner in the development of a risk management plan. Consultation with an attorney experienced in accountant risk management plans should always take place prior to implementation of any plan.

I. Communication with New and Existing Clients

The Proposal Process

The proposal process not only allows a prospective client to size up the accounting firm, but also allows the firm to size up the prospective client. The proposal process should include a face-to-face meeting with the prospective client’s decision maker and key client contacts. All proposal meetings should cover the scope and arrangements of any potential engagements. It is important to focus on making the firm’s deliverables clear, as opposed to promising a specific outcome from the engagement. Although puffery of the firm’s abilities is a temptation, client’s expectations should be in line with the firm’s abilities. The identification of quality clients is also of paramount importance to mitigating risk.

High-risk clients increase the liability exposure of even the most careful accounting firms. All too frequently, when problems arise during or subsequent to a high-risk client engagement an attempt will be made to (a) blame the firm for any misstatements which are found in a client’s financial statements or (b) hold the firm liable for substantial losses suffered by various persons who allegedly “relied” on the misstated financials, including the client and the client’s shareholders, lenders and trade creditors. In order to reduce litigation exposure, it is imperative that accounting firms carefully screen out high-risk clients. Unfortunately, such clients cannot be dealt with simply charging higher fees, because, if litigation ensues, defense costs and damage exposure will almost certainly greatly exceed the fees generated.

Although it is impossible to list every type of problem client, the following are common examples of situations that can and should be avoided, or, at a minimum, be approached with significant caution and a realistic assessment of the risks:
• Clients engaging in improper or illegal activities.
• Clients with financial problems
• Clients with poor internal controls
• Clients with high management turnover
• Clients with uncertain futures
• Clients which frequently change or sue accountants
• Clients shopping for an accountant
• Clients involved in substantial litigation
• Clients involved in a material amount of related party transactions
• Clients requiring expertise not possessed by the firm
• Clients that are unable or unwilling to pay fair prices

In order to avoid high-risk clients, accounting firms should establish formal screening procedures that must be followed before a new client is accepted. Among other things, firms should incorporate the list above as well as other identified risks. Firm’s management should determine whether the litigation risks outweigh the expected financial benefits.

In addition, the firm should make detailed inquiries of the predecessor accountants before accepting a new client. Such inquiries should be directed to such matters as management’s integrity, any disagreements between the predecessor accountant and management with respect to GAAP, GAAS or other significant matters, and the reasons why the prospective client is seeking to change accountants. In addition, the firm should also review its predecessor’s work papers before taking on the new matter. Absent unusual circumstances, an accounting firm should refuse to accept any client who refuses to authorize the predecessor accountants to communicate with the new accountant or to make its work papers available to the successor accountant.

Marketing Professional Services

Marketing materials prepared for an accounting firm, although beneficial, can potentially add “fuel to the fire” of litigation if not properly prepared. Whether marketing materials are prepared by the firm’s in-house marketing department, or by independent consultants, they should portray an objective and accurate picture of the firm. These materials often times include statements on the firm’s history, clients, and services available. Additionally, client proposals frequently include the experiences and qualifications of the firm’s employees. While this information may be readily available to the public through independent investigation, the accounting firm should take care to respect the client’s and the employee’s expectation of privacy.

Moreover, the firm’s marketing material should not create the perception of expertise in a particular area when the firm neither has the requisite experience nor the ability to hire individuals to meet the expectations of the client. By providing services to a client without the requisite experience, the accounting firm is inviting a suit for negligence.
From traditional ad copy to internet banner ads, accounting firms have more avenues than ever before to present marketing material to the public. Accordingly, accounting firms should be even more diligent in policing their marketing material. Firms should not allow non-professionals to be the sole authors and reviewers of the marketing material. As such, top level management review of all marketing material should be mandatory. Additionally, firms should conduct regular periodic reviews of marketing materials for content and updating. This review will ensure that stale marketing materials which could possibly contain inaccurate information does not make its way into potential or actual litigant’s hands.

**Engagement Letters**

Accounting firms are frequently sued for having failed to perform services or rendered advice that their client alleges the firm agreed, or were expected, to render. Accordingly, the profession has long encouraged its members to use engagement letters to establish a clear understanding of the services to be performed. Moreover, the engagement letter defines the responsibilities between the accounting firm and the client.

Over the years, and especially in these litigious times, engagement letters have been used with greater frequency, and have evolved to include language addressing topics related to the engagement, such as statements about the limitations of the services provided, particularly in the case of audit, attestation, and accounting and review services. It is even more important to fix the terms of a firm’s engagement where the services to be rendered are of a non-standardized nature, such as in consulting engagements. Engagement letters have also been used to establish an understanding of fee and billing arrangements.

Accountants should maintain standard forms of engagement letters on their computer systems so that an engagement letter can be issued to a client at the commencement of each engagement with little or no delay. As a practical matter, if a firm delays in delivering an engagement letter, the client will feel no great urgency to sign and return it. If an accounting firm wishes to receive the signed letter before it starts performing services for the client, it must move quickly in generating the appropriate engagement letter.

Some accountants are reluctant to begin using engagement letters for long standing clients, they fear that such clients might be offended by being asked to formalize their agreement after having operated on "trust" for so many years. This is largely an irrational fear as no client has any legitimate basis for refusing to acknowledge the terms of the engagement, and any client that simply objects to putting the terms of an engagement in writing may not be a client worth having.

Occasionally, an accountant may encounter a client who balks at signing an engagement letter. The accountant should be prepared to explain the importance of engagement letters to such a client. Some suggested responses to clients who are reluctant to sign engagement letters are listed below:

- The engagement letter is intended to help the client fully understand exactly what the accounting firm is doing. It lists any limitations of those services so that the client will not allow important functions to fall between the cracks.
• Insurance companies strongly urge accountants to utilize engagement letters in all of their engagements. Some even refuse to provide coverage to accountants that do not follow this practice.

• Accountants may be criticized for unprofessional conduct by failing to utilize engagement letters.

While it is always preferable to have a signed engagement letter, even an unsigned letter will go a long way in reducing an accountant's exposure to liability claims. This is because it presents some, if not conclusive, evidence of the terms of the firm's engagement. Therefore, a firm can gain some advantage simply by sending an engagement letter to the client.

Accountants should keep a record of all engagement letters sent to their clients and should be prepared to follow up if a client does not promptly sign and return the letter. In most cases, a firm should not proceed with an engagement until it has received a copy of the engagement letter signed by the client.

Many accountants have adopted the practice of including provisions in their engagement letters that cover each subsequent annual engagement unless subsequently modified. These firms receive a letter in the first year of a client relationship and do not require a new letter in each subsequent year. While this is a legally permissible practice, it is not advisable. This is because a client's operations change over the years as does the scope of an accountant's engagement. Since virtually all accountants today utilize computers as a part of their daily routine, the generation of engagement letters only requires a few minutes of the accountant's time. Moreover, requiring a new letter each year forces the accountant to focus on the scope of services that he or she will be providing and to reflect upon the potential liability exposure the firm faces in performing that engagement.

II. Documenting Client Communications

Corresponding with the Client

The documenting of a conversation with a client can go a long way in defending litigation where the client’s understanding is at issue. At the very least, telephone conversations with the client should be documented in the form of a memorandum to the client’s files including the date, time, issue, personnel involved in the call, and the accountant’s response to the inquiry. Where the accountant’s response to the client is in the form of advice, it is generally prudent to follow up the call with a letter to the client documenting the details of the conversation so that there is no confusion as to what advice was given.

Other Documentation Issues

All work product drafts should include the date and time, and the label “Draft – For Discussion Purposes Only.” In addition to these labeling procedures, a cover letter should accompany any work product drafts identifying them as such and asking for their return upon completion of the issuance of the final work
product. A copy of each draft should be maintained in the work paper files. When feasible, a list of which drafts were issued to should also be maintained. This allows for quick and convenient gathering of drafts when the time comes to dispose of such documents in accordance with the firm’s document retention guidelines.

**File Management At The End Of The Engagement**

At the conclusion of the engagement several steps should be taken to ensure that only accurate and relevant work paper files are maintained in the client files. Planning notes for the engagement should be reviewed and retained. “Open points” lists should be discarded. Draft or uncompleted work papers should be discarded. All client files should be returned to the client, and, if possible, proof of the return in the form of a signed receipt or acknowledgment should be retained. All files maintained personally by the staff should be sorted, filing important documents and discarding the rest. The client’s work files should be maintained together in one location to facilitate the ease of locating files in the unfortunate event that your client’s files are subject to a subpoena.

**Document Retention**

The accounting profession, by necessity, generates volumes of paper in connection with the performance of client engagements. A practical and systematically implemented document retention policy is of the utmost importance to protect the accounting firm and your client.

Most accountants do not realize that document retention issues that may arise during litigation, or otherwise, also encompass several categories of documents that are not "ordinarily" considered part of a client's files. The benefits of implementing a document retention policy might not be realized because of stray records of client services. The following is a partial checklist of documents to be considered part of a client file:

- budgets, time summaries and/or daily time records;
- work papers, including interim work papers; indexes to work papers;
- reports, and/or opinions relating to the client;
- correspondence files;
- continuing audit files or permanent files;
- personal calendars and diaries;
- billing records;
- memoranda and notes including
  - exit meeting notes,
  - engagement reports,
  - interview notes,
  - senior’s memoranda,
  - partner’s memoranda,
  - research memoranda,
- review notes,
- second partner's review;
- audit plans, audit programs and other planning documents;
- appraiser's reports;
- peer review reports;
- audit check lists;
- engagement letters;
- organizational charts;
- handwritten notes;
- abstracts of company documents;
- financial statements, including drafts;
- flow charts;
- management letters and reports;
- internal control questionnaires;
- interoffice reporting packages;
- lead schedules;
- representation letters;
- manuals (and all supplements), including
  - audit handbooks,
  - audit partner lists,
  - audit manual bulletins,
  - training materials,
  - accounting manuals,
  - reference manuals; personnel evaluations; and
- SEC letters of comment, replies thereto and other documents relating thereto.

A review of this list reveals that there are many types of documents that are typically considered part of a client file which relate to professional services rendered to clients. These documents would include: personal calendars and diaries; daily time records; work-in-process records; client billing, disbursements, and payment records; personal correspondence; and personnel files. Although these materials are not usually included physically in the files maintained for clients, the careful practitioner should not discard them prematurely -- such records are relevant and discoverable in a professional liability litigation. Indeed, items such as calendars and billing records may prove the most useful tool for refreshing someone's recollection as to work performed or meetings attended, especially when an accountant's adversary is promoting a different version of events.

The primary impact on client file retention is economic. Accountants face ever-increasing costs to retain client files. These costs include: storage space; maintaining security for files; organizing, indexing and cataloging stored files; transporting files to and from storage; and, equipment to organize files, such as file shelving. In many cases, emerging technologies, including microfiche, electronic and magnetized storage media have not developed to the point of providing cost-effective solutions to the retention dilemma.
As a practical matter, the retention of working papers and client records may become useful, and sometimes necessary, for the client. In this regard, retention of working papers may be required for the preparation of SEC reports, tax returns, and reports to other government agencies.

When, in the context of either professional liability litigation or other litigation involving a client, an accountant destroys or discards client files, the accountant may face serious and adverse legal consequences if the destruction occurs in bad faith. Although the court decisions addressing these consequences are numerous, and by necessity tend to focus on the unique facts and circumstances present in a particular case, there are six significant legal risks a practitioner may face if document destruction occurs in bad faith.

- The imposition of criminal sanctions, fines, or penalties for obstruction of justice, spoliation of evidence or hindering law enforcement investigation. Of course, these penalties generally can arise when there is an ongoing governmental investigation into the affairs of an entity for which the accountant is providing professional services.
- Entry of an order citing contempt of court for failure to comply with subpoena.
- Entry of a court-ordered judgment by default for a plaintiff in a civil case and the assessment of money damages against the professional. This harsh remedy does require extreme bad faith, and conduct tantamount to the destruction of evidence, by the party destroying documents.
- Award of discovery sanctions, including costs and attorneys' fees incurred by an opposing litigant related to the discovery, investigation, and remedial action required as a result of the document destruction.
- Jury instruction that an adverse inference can be drawn to the effect that destroyed documents would either have favored the plaintiff or harmed the legal position of the defendant, for purposes for rendering a verdict. One court has held that the destruction of business records, which the owner should have "appreciated" would be relevant to "reasonably foreseeable litigation" was enough to justify an "adverse inference" in the litigation. This holding occurred despite the fact that the documents at issue were destroyed "years before the commencement of litigation" pursuant to a "good faith" policy adopted and implemented in the ordinary course of business.
- A party wrongfully destroying documents may, in some states, face independent civil liability for the tort of spoliation of evidence.

The safest way for a professional to defend against a claim that documents have been destroyed in bad faith is the adoption and implementation of a reasonable document retention policy. There generally are as many different formulae for what should be contained in a document retention policy as there are...
lawyers drafting them. Some of the key ingredients to an effective retention policy are: a clear definition of which documents will be permanently retained and which will not; the duration of retention; under what circumstances the documents must be returned; and, what procedures may apply if the documents may be relevant to a litigation that subsequently may arise.

III. Dealing with Problem Clients

Clients Experiencing Internal Disputes

Accounting firms occasionally face involvement in serious disputes between two or more of their clients. For example, various members of a partnership which retained a firm might be engaged in a bitter struggle for control of the partnership’s business and assets. In such circumstances, the firm’s goal must be to avoid becoming the target of one or more of the feuding clients in any ensuing litigation. Avoiding entanglement in such litigation, depending on the situation, may include remaining neutral or representing only one of the parties. When neutrality is appropriate, it requires a consistent appearance of impartiality. Accordingly, requests for documents should be viewed with caution and consideration should be given, subject to confidentiality restrictions, to providing both sides with equal access. In some circumstances, to avoid the appearance of partiality or other criticism, documents should be produced only pursuant to a lawfully issued subpoena.

In some circumstances, "neutrality" may increase, rather than lessen, the chances of being targeted in litigation between feuding clients. Emotions often run high in these situations and a client’s sense of being "abandoned" by a once close and trusted advisor may lead to vindictiveness. Indeed, marital and business separations tend to be highly charged affairs in which anyone deemed to be a "friend" of the enemy becomes an enemy. Since it is not always easy to know which litigation avoidance strategy is best, accountants should immediately seek the advice of legal counsel when litigation develops between two or more of their clients.

Disagreements with the Client

Occasionally, an accounting firm and management of a client disagree over matters such as (i) the application of accounting principles to the client’s specific transactions and events, (ii) the basis for management’s judgments about accounting estimates, (iii) the scope of the firm’s audit, (iv) disclosures to be included in the client’s financial statements, and (iv) the wording of the auditor’s report. While the firm should remain open-minded to all reasonable approaches suggested by the client when differences arise, it should never endorse a position it knows is wrong or accede to a client’s wishes out of fear that it will lose the client’s business. If the firm yields to its client’s position in inappropriate circumstances, it will assume litigation risks which will outweigh any short-term benefits obtained by accommodating the client.

In the unfortunate event that the accounting firm is forced to withdraw from an engagement, the withdrawal provision contained in the engagement letter will have provided the client with notice that withdrawal was a possibility. Withdrawal from an engagement or termination of a client relationship is a potentially high risk situation. Prior to the withdrawal or termination, the lead partner on the engagement
should consult with others in the firm to discuss the matter. Additionally, legal counsel should be sought prior to taking any action. The termination or withdrawal letter should be carefully drafted with the aid of legal counsel. Certain key provisions should be contained in the letter including: the effective date of withdrawal or termination; reasons for withdrawal or termination; possible courses of action which would cure the problem and allow for a continuation of services; and, an offer to cooperate with the successor accountants. This type of correspondence, as with all important client communications, should be sent return receipt requested.

**Conclusion**

Faced with tougher competition and less favorable economic conditions, accounting firms are forced to diligently apply a cost versus benefit analysis to new and continuing clients. The cost versus benefit analysis should account for the litigation risks associated with a client, and the accountant’s ability to minimize those risks. Frequently, the accountant is the first line of defense when it comes to litigation aimed at the accountant’s work. The implementation of an effective risk management plan regarding current and potential clients can go a long way in minimizing the damages that can result from litigation.

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